Nos. 15,461 - 15,462

United States
COURT OF APPEALS
for the Ninth Circuit

L. H. PIERCE, Appellant

v.

UNITED STATES OF AMERICA, Appellee

UNITED STATES OF AMERICA, Appellant

v.

LENA L. PIERCE, Appellee

BRIEF FOR L. H. PIERCE AND LENA L. PIERCE

On Appeals from the Judgments of the United States District Court for the District of Oregon

MORRIS J. GALEN,
JACOB, JONES & BROWN,
522 Public Service Building,
Portland 4, Oregon,
Of Attorneys for L. H. Pierce and Lena L. Pierce.

STEVENS-NESS LAW PUB. CO., PORTLAND, ORE. 7-57

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The District Court rendered no opinion. Its Findings of Fact and Conclusions of Law are to be found at R. 25-31.

JURISDICTION

These consolidated appeals involve federal income taxes. L. H. Pierce and Lena L. Pierce, the taxpayers,

are husband and wife. The taxes in dispute for the taxable year 1946 were returned and paid on or about March 15, 1947 (R. 17-18). On or about June 7, 1949, L. H. Pierce and Lena L. Pierce each filed claim for refund of the sum of $1,553.55 (R. 20-21). No decision was rendered by the Commissioner of Internal Revenue within six months after the said claims were filed nor at any date thereafter (R. 20-21).

Within the time provided in Section 3772 of the Internal Revenue Code of 1939, and on December 6, 1954, L. H. Pierce and Lena L. Pierce brought actions in the District Court of the United States for the District of Oregon for the recovery of the taxes paid (R. 3). Jurisdiction was conferred on the District Court by 28 U.S.C. Section 1346.

On October 29, 1956, judgments were respectively entered in the case of L. H. Pierce in favor of the United States of America, dismissing the Complaint, and in the case of Lena L. Pierce in her favor in the amount of $1,553.55 with interest (R. 31-33).

Within sixty days and on December 5, 1956, notices of appeal were filed by the Government and L. H. Pierce from the judgments respectively adverse to each (R. 34-35). On December 5, 1956, L. H. Pierce filed a cost bond on appeal (R. 35).

QUESTIONS PRESENTED

1. Whether, within the meaning of Section 122(d)(5) of the Internal Revenue Code of 1939, in determining the net operating loss carryback to which a taxpayer is

entitled, deductions not attributable to the particular trade or business in which an operating loss is sustained are allowed to the extent of the gross income of the taxpayer not derived from such trade or business.

2. Whether, within the meaning of Section 122(d)(5) of the Internal Revenue Code of 1939, the trade or business regularly carried on by a taxpayer constitutes, in a community property state, a trade or business of the spouse of the taxpayer for the purposes of computing the net operating loss deduction available to such spouse?

STATEMENT

Findings of Fact in the cases (R. 25-29) were based on stipulated facts contained in the Pre-trial order (R. 14-24), where both actions were consolidated for trial (R. 15).

The taxpayers, L. H. Pierce and Lena L. Pierce, are husband and wife who filed separate individual income tax returns for the years in question, 1946 and 1948. Taxpayers were residents of Multnomah County, Oregon, and in accordance with the community property law of that state each taxpayer reported one-half of the salary income of L. H. Pierce as his or her individual share of the community property (R. 25-26, 28).

Both taxpayers kept their books and filed their returns on a calendar year and cash receipts and disbursement basis. For the taxable year 1946 the taxpayer husband had gross income of $66,662.26 and net income of $65,790.16. For the same year the taxpayer wife had gross

income of $66,662.25 and net income of $65,825.45. Both taxpayers filed their separate 1946 returns with the Collector of Internal Revenue, Portland, Oregon, on or about March 15, 1947, showing a tax liability in the amount of $36,456.66 for the husband and $36,112.31 for the wife which each paid to the Collector (R. 26-27).

The taxpayers were equal partners in the L. H. Pierce Auto Service which was organized on January 1, 1935. Taxpayers shared profits and losses equally for taxable years 1935 through 1948, inclusive. Taxpayers each owned 50% of the issued and outstanding stock of the Pierce Trailer & Equipment Co., an Oregon corporation, organized on or about April 2, 1947. The partnership had engaged in the manufacture of trailers until the corporation was organized, at which time the latter conducted the trailer business. The partnership then leased property it owned to the corporation and conducted other operations not connected with the business of the corporation (R. 27-28).

For the taxable year 1948 the taxpayers had income and losses as follows: The partnership, L. H. Pierce Auto Service, sustained a net operating loss of $4,193.12. As a result of such net operating loss, each of the taxpayers sustained an operating loss of $2,096.56, which was reported by each taxpayer on his or her separate 1948 federal income tax return. The corporation, Pierce Trailer & Equipment Co., paid the taxpayer husband $6,000.00 for his services as president, which was reported, under the community property law, as $3,000.00 on the separate 1948 federal income tax return by each taxpayer. Each taxpayer sustained a nonbusiness casu-

alty loss and deducted $3,391.47 on his or her separate 1948 tax return on account of such loss (R. 28-29).

On June 7, 1949, each taxpayer filed a separate claim for refund of taxes paid in 1946 in the amount of $1,553.55 with the Collector of Internal Revenue, Portland, Oregon. The claims were based upon an alleged overpayment in 1946 assertedly due to a net operating loss carryback from 1948 in the amount of $2,096.56 in each case resulting from the operation of the partnership (R. 29). The court below concluded that the taxpayer wife was entitled to the carryback and relief in the full amount of her claim, and that the taxpayer husband was not entitled to the carryback and any relief upon his claim (R. 29-31). Judgments were rendered accordingly (R. 31-33), and these appeals followed.

STATEMENT OF POINTS TO BE URGED

The points to be urged by L. H. Pierce in his appeal from the judgment in favor of the United States of America are as follows:

1. The District Court erred in holding that the salary received by L. H. Pierce as president of Pierce Trailer & Equipment Co. must, in the computation of the net operating loss deduction under Section 122 of the Internal Revenue Code of 1939, be offset against the net operating loss sustained by him as a partner of L.H. Pierce Auto Service.

2. The District Court erred in holding that L. H. Pierce was not entitled to any net operation loss deduc-

tion for the year 1946 under the provisions of Section 23(a) of the Internal Revenue Code of 1939.

3. The District Court erred in dismissing the Complaint of L. H. Pierce.

ARGUMENT

I.

In Determining the Net Operating Loss Carryback to Which a Taxpayer Is Entitled, Deductions not Attributable to the Particular Trade or Business in Which the Taxpayer Sustained an Operating Loss Are Allowed to the Extent of Gross Income of the Taxpayer not Derived from Such Trade or Business.

The issue presented is not the definition of the term "trade or business" as used in the net operating loss provisions of the Internal Revenue Code of 1939. That definition is only conclusive if the Court were to hold that salary income is not income from "trade or business," in which event taxpayers would be entitled to judgment in each case. While there is ample authority[1] to justify such a holding and judgment, taxpayers are entitled to judgment in each case even should this court hold that the salary of L. H. Pierce was attributable to a "trade or business" regularly carried on by him.

Taxpayers' contention is that they are not required by Section 122(d)(5) to combine the "profits" of the

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[1]*McGinn v. Commissioner,* 76 F. 2d 680 (9th Cir. 1935); *Hughes v. Commissioner,* 38 F. 2d 755 (10th Cir. 1930); *Cunningham v. Commissioner,* 20 T.C. 65 (1953); *Luton v. Commissioner,* 18 T.C. 1153 (1952); *Montgomery v. Commissioner,* 17 B.T.A. 1308 (1929).

alleged business of L. H. Pierce with the operating loss of the partnership business conducted by the taxpayers in arriving at the net operating loss carryback. The net operating loss deduction claimed by the taxpayers for 1946 stems from the operating loss of the partnership. Nothing in Section 122 defines the net operating loss deduction as the combined net operating loss resulting from all the business operations of the taxpayer or requires that the profits and losses of each business be combined before making the adjustments set forth in Section 122(d)(5).

An examination of the language and of the history of the net operating loss provisions leaves no doubt that taxpayers in computing their net operating loss carryback may offset against income not derived from the particular business in which the loss was incurred their deductions not attributable to the operation of such trade or business. The net operating loss deduction is intended to prevent a business with erratic earnings from being penalized by the payment of taxes in the years in which it operates at a profit without the benefit of any offsetting deductions for the years in which it operates at a loss. The exceptions and limitations provided in Section 122(d) are for the purpose of insuring that only an economic loss will be taken into account. See S. Rep. No. 648, 76th Cong. 1st Sess., p. 1 (1939-2 Cum. Bull. 524); H. Rep. No. 855, 76th Cong. 1st Sess., p. 9 (1939-2 Cum. Bull. 504, 510).

There is no dispute that each of the taxpayers in the instant case sustained a net operating loss of $2,096.56 in 1948 (R. 28). Unless effected by the provisions of

Section 122(d)(5), this net operating loss carries back to 1946 and becomes a net operating loss deduction available to each of the taxpayers.

The pertinent provisions of section 122 are as follows:

> "(a). Definition of Net Operating Loss. — As used in this section, the term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).
>
> "(b) . . .
>
> "(1) . . .
>
> "(A) . . . If for any taxable year beginning after December 31, 1941, and before January 1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years. . . .
>
> * * *
>
> "(d) . . .
>
> "(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall . . . be allowed only to the extent of the amount of the gross income not derived from such trade or business . . ."

The net operating loss deduction thus is the net operating loss carryback reduced by certain adjustments intended to prevent net losses from being used as a deduction by the taxpayer who has not suffered any economic loss by reason of the fact that his income contains non-taxable items (as in the case of percentage depletion and exempt interest), long term capital gains or by reason of the fact that the taxpayer's nonbusiness deductions exceed his income not derived from the business in which the loss was incurred.

Had Congress intended that a taxpayer combine all of his trade or business activities for purposes of determining the net operating loss, it could have accomplished this result with a very slight change in the language of Section 122(d)(5). The mere substitution of the word "a" for the word "such" would have changed the meaning of the section so as to encompass all business activities of a taxpayer. The use of the word "such" must clearly have been intended to limit the application of Section 122(d)(5) so as to preclude a taxpayer from increasing the amount of his net operating loss by the amount of his nonbusiness deductions.

An examination of Section 122 shows that Congress intended the term "such trade or business" to relate to the trade or business of the taxpayer in which the net operating loss was sustained. To read into the statute the word "a" in place of the word "such" is to impose a limitation not intended by Congress. Each business activity must stand by itself and a net operating loss shall be diminished only by the amount that the taxpayers' other income exceeds the taxpayers' other deductions. Any other interpretation would distort the statute and work on the taxpayers in the instant case a hardship not intended by Congress.

Both *Folker v. Johnson,* 230 F. 2d 906 (2d Cir. 1956), and *Overly v. Commissioner,* 1957 P-H Par. 72,677 (3d Cir., decided April 29, 1957), were decided upon the question of whether an executive's services as such constituted engaging in a trade or business. The court in neither case discussed or apparently considered whether a taxpayer was required to combine the income from

all business activities in order to determine the net operating loss carryback which he claimed.

The general effect of Section 122 is that the loss from the operation of a business is computed without regard to other items, which are not income from or deductions of that particular business. Then the operating loss as so determined is reduced to the extent that the other income of the taxpayer exceeds the other deductions on his return. The difference as so computed is the net operating loss and it carries back and becomes the net operating loss deduction to which the taxpayer is entitled.

This clearly is the result intended by Congress. In his return, a taxpayer reports the profits and losses of each business activity separately. The results are not combined except to determine the total income and amount of tax owed by the taxpayer. Nothing in Section 122 indicates that Congress intended that separate business activities be combined for purposes of determining the net operating loss, except to prevent a carryback or carry forward where there has been no economic loss. To combine the results would be to ignore the theory and purpose of the net operating loss provisions, which permit taxpayers to equalize the tax burden on a business which may in some years sustain a loss. A taxpayer is entitled to equalizing benefits of the net operating loss provisions to the extent that as a result of an operating loss he had suffered an economic loss, after the application of section 122(d). Had Congress intended any other result to prevail where a taxpayer conducts more than one business activity, it would have so stated the law in clear and unambiguous language.

II.

A Trade or Business Regularly Carried on by a Taxpayer Does Not Constitute a Trade or Business Regularly Carried on by the Spouse of the Taxpayer.

The Oregon Community Property Act under which taxpayer wife, Lena L. Pierce, included in her separate 1948 tax return $3,000.00, representing one-half of her husband's salary income (R. 25), was put into effect July 5, 1947, and was repealed on April 11, 1949, and thus was in force during 1948 (Oregon Laws of 1947, c. 525; Oregon Laws of 1949, c. 349). It is not disputed that the community property system was imposed on married persons, such as these taxpayers, domiciled in Oregon during 1948. I.T. 3868, 1947-2 Cum. Bull. 49. The District Court concluded that although the salary income received by L. H. Pierce was attributable to the trade or business regularly carried on by him as a corporate executive, his wife, Lena L. Pierce, did not engage in any such trade or business, and therefore the amount reported by her under the Oregon Community Property Law did not constitute income to her from a trade or business regularly carried on by her.

The issue presented with respect to Lena L. Pierce is not controlled by the nature of the income earned by her husband as maintained by the Government. To the contrary, the question may be simply stated as follows:

Did taxpayer Lena L. Pierce receive $3,000.00 as income in 1948 attributable to the operation of a trade or business regularly carried on by her?

The answer, based on the facts in this case, must be "no."

In *Graham v. Commissioner,* 95 F. 2d 174 (9th Cir. 1938), relied upon by the Government, this Court construed the meaning of the term "earned income" as used in Section 31 of the Revenue Act of 1928. The pertinent provision of the statute construed by this Court in the *Graham* case provided as follows:

> "Sec. 31. Earned Income Credit.
>
> "(a) Definitions. For the purposes of this section—
>
> "(1) 'Earned Income' means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. . . . ."

The Government there contended that the phrase "personal services actually rendered" meant personal services actually rendered by the taxpayer. This Court declined to read the language "by the taxpayer" into the statute, stating:

> " . . . if Congress had intended such a limitation, it would have expressed that intent. It did, in the same paragraph, where limitations were intended, express such intent by using the words 'by him' and 'by the taxpayer'. No such words were used in the first part of section 31(a)(1). We conclude, therefore, that no limitation was there intended."

In the instant case, the Government would have this Court ignore the language "regularly carried on by the taxpayer" in construing Section 122(d)(5). The decision of this Court in the *Graham* case was based upon the absence of such language from the statute. The presence of the words "by the taxpayer" in Section 122(d)(5) is controlling, limiting its application to the taxpayer who actually engages in the business activity.

Lena L. Pierce did not engage in any trade or business as a corporate executive. It is the fact of engaging in a trade or business that determines whether adjustments under Section 122(d)(5) are to be made. The Government has incorrectly looked to the nature of the income earned by the husband. Subsection (5) relates to income or deductions not attributable to the "trade or business regularly carried on *by the taxpayer.*" (Emphasis supplied). The taxpayer in this case is the wife. She filed separate returns and is entitled to have her taxes computed in accordance with income and deductions set forth on her returns.

The reasoning of this Court in the *Graham* case applies equally to the case at bar. That case, as well as *McLarry v. Commisioner,* 30 F. 2d 789 (5th Cir. 1929), cited by the Government, supports taxpayer Lena L. Pierce. She did not receive any income in 1948 attributable to the operation of a trade or business regularly carried on by her. Therefore, she is entitled to deduct the nonbusiness casualty loss sustained by her in 1948 in the amount of $3,391.47 "to the extent of the amount of gross income not derived from such trade or business." She had such gross income in the amount of $3,000.00, so Section

122(d)(5) limits her deduction, in determining her net operating loss carryback, to that amount. The balance of the nonbusiness casualty loss is not taken in consideration, and taxpayer Lena L. Pierce's net operating loss carryback is $2,096.56, the amount of her share of the net operating loss sustained by the partnership.

The net operating loss provision is a relief provision and, as such, should be liberally construed to carry out the purpose and intent of Congress. The judgment in favor of Lena L. Pierce in Case No. 15,462 is correct.

CONCLUSION

For the reasons above given the judgment of the District Court for the Defendant and dismissing the Complaint should be reversed and judgment directed for the taxpayer in the case of taxpayer husband on taxpayer's appeal (*L. H. Pierce v. United States;* No. 15,461), and the judgment of the District Court against the Defendant in the sum of $1,553.55 with interest should be affirmed in the case of the taxpayer wife (*United States v. Lena L. Pierce,* No. 15,462).

Respectfully submitted,

MORRIS J. GALEN,

Of Attorneys for L. H. Pierce and Lena L. Pierce.

JACOB, JONES & BROWN,
522 Public Service Building,
Portland 4, Oregon.